

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-4452-99
LRAverbeck

date:

to: Chief, Examination Division, Ohio District
Attn: Diane Camper

from: District Counsel, Ohio District, Cincinnati

subject: [REDACTED]
Request for Advisory Opinion

This responds to your second request for assistance in regard to issues arising from [REDACTED]'s payment in settlement of a lawsuit for punitive and compensatory damages. Our Answer to the previous request was sent on November 30, 1999.

ISSUES

1. Whether amounts paid in settlement of claims for "upper-tier" damages are deductible as compensatory damages.

2. Pursuant to review of our prior memorandum by National Office, we must revise our advice regarding a refund of tax paid in earlier years under the Claim of Right doctrine.

CONCLUSION

1. "Upper-tier" damages can be considered compensatory. We therefore recommend no change from our conclusion in our prior Advisory Memorandum. A portion of the settlement which represents the compromise of compensatory fines and damages, including actual and "upper-tier damages," should be allowed as a deduction. We still believe that a portion of the settlement should be allocated to the punitive damages and, therefore, not allowed as a deduction.

2. [REDACTED], X is not entitled to a refund of tax paid in earlier years under the Claim of Right doctrine. Section 1341 does not provide a Claim of Right where the taxpayer repays money that was obtained by fraud. In addition, section 1341 only applies when there is a repayment of the same item that was previously included in gross income. Clearly, this section would not apply to interest or "upper-tier" damages.

FACTS

The facts are the same as set out in the first Advisory Memorandum. In addition, this memorandum addresses the nature of the "upper-tier" damages. It is our understanding that the "upper-tier" damages represent the excess amount charged to the government by prime contractors who had subcontracts with [REDACTED]. It was on these subcontracts between [REDACTED] and the prime contractor that [REDACTED] inflated the costs. These inflated costs were passed on to the government at an even higher rate, after the prime contractors marked up the subcontractor's charges at an allowable rate.

DISCUSSION

Issue 1: "Upper-tier" damages are compensation for actual damages incurred by the government and can be considered compensatory. They are meant to compensate the government for the overcharges from prime contractors which resulted from [REDACTED]'s overcharges to the prime contractors. If [REDACTED] had lost at trial and paid the government the entire amount of "upper-tier" damages, that amount would be deductible. However, [REDACTED] reached a settlement agreement with the government for less than the total amount of damages, compensatory and punitive, requested by the government. The problem of allocating the settlement amount to the various damages and fines which were compromised remains unresolved.

Our previous Advisory Memorandum explained the law concerning the deductibility of damages, fines and penalties under section 162 of the Internal Revenue Code. It is not necessary, therefore, to repeat the complete explanation here. We will just highlight the relevant points.

Whether payment of a fine or penalty is deductible depends on the purpose the fine or penalty was meant to serve. If a civil penalty is imposed for purposes of enforcing the law and as punishment for violation of the law, it is not deductible. Talley Industries, Inc. v. Commissioner, 116 F.3d 382, 385-86 (9th Cir. 1997) (citing Southern Pac. Trans. Co. v. Commissioner, 75 T.C. 497, 653 (1980)). If the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it is deductible because it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f). Id.

The amount which [REDACTED] paid to the government in compensation for the government's actual losses due to the overcharges, as well as damages paid to compensate the government for other expenses due to the overcharges, are deductible expenses. The "upper-tier" damages paid by [REDACTED] compensate the government for additional losses it incurred due to the overcharges. We don't think it matters that these overcharges were not directly billed by [REDACTED]. They were caused by [REDACTED].

The amounts which [REDACTED] paid the government in settlement of potential liability for fines or penalties, including the treble damages provision of the False Claims Act, are not deductible expenses. When there is no agreement for the allocation of settlement amounts between deductible and non-deductible expenses, the courts will consider the circumstances surrounding the agreement to determine the intent of the parties regarding the nature of the payments. We do not yet have that information in this case. [REDACTED], one of the Department of Justice attorneys who settled the case with [REDACTED], is in the process of gathering relevant settlement documents for us to review. We don't anticipate that these documents will give a clear answer as to how the settlement should be allocated, but they should provide some support for our position that the entire amount is not deductible.

The court in the Talley Industries cases stated that it is the taxpayer's burden to demonstrate entitlement to a particular deduction. Talley Industries, Inc. v. Commissioner of Internal Revenue, 116 F.3d 382, 387-88 (9th Cir. 1997) (citing Norgaard v. Commissioner, 939 F.2d 874, 877 (9th Cir. 1991)). Thus, in this case, in order to deduct the entire settlement payments, [REDACTED] must show that the parties intended the entire amount of the settlements to represent compensation to the Government for its losses. As in Talley Industries, it is likely that [REDACTED] and the government intended for the settlement to encompass all possible claims against [REDACTED] including the punitive damages portion of the treble damages provision of the False Claims Act, which amounts would not be deductible.

[REDACTED] asserts that since the amount of "upper-tier" damages, along with interest which the government sought to recover in addition to the direct overcharges by [REDACTED] would amount to more than the amount of the settlement, the entire settlement amount should be deductible. (No authority for this position was indicated in the memo.) In Talley Ind. v. Commissioner, T.C. Memo 1999-200, the Tax Court rejected a similar argument:

We reject petitioner's contention that the disputed portion of the settlement agreement cannot be considered a penalty because the Government's actual losses purportedly exceeded the entire \$2.5 million settlement payment.

77 T.C.M. (CCH) 2191, 2196 (1999).

We therefore make no change in our earlier position that the settlement amount that [REDACTED] made to the government is not entirely deductible, but an allocation should be made between the amounts that represent compensatory damages and punitive damages. The amounts representing compensatory damages are allowable as a deduction. The amounts representing punitive damages are not.

Issue 2: Section 1341 of the Internal Revenue Code provides for either a deduction or a reduction in tax when restitution is made of an amount which was included in taxable income in a previous taxable year under a claim of right. Specifically, the Internal Revenue Code provides for an adjustment of income tax where an item was included in gross income in a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to such item and a deduction of more than \$3,000.00 is allowable for the taxable year because it was later established that the taxpayer did not have an unrestricted right to such item.

However, no deduction under Section 1341 is allowed where the repaid amounts were illegally or wrongfully obtained, such as through fraud or embezzlement or any receipt of earnings which the taxpayer knew he did not have a legal right to claim. In such a situation, the funds were not received under a claim of right. The government's complaints alleged fraud. If [REDACTED] intentionally overcharged the government on the contracts and knew that it did not have a legal right to funds obtained, the adjustment provided under Section 1341 cannot be claimed. The District Court, in McKinney v. United States, 574 F.2d 1240 (5th Cir. 1978), cert. denied, 439 U.S. 1072 (1979), decided that when a taxpayer receives sums and it could not have appeared to the taxpayer at the time that he had any right to the funds, the taxpayer is not entitled to a deduction under Section 1341, even though he may be able to claim a deduction in the year the amounts are refunded under Section 162. From the limited facts we have, it appears that [REDACTED], by its subsidiary, knew it was overcharging the government on prime contracts as well as subcontracts with other prime contractors. Thus, [REDACTED] is not entitled to a deduction under Section 1341, even for amounts that were included in gross income

in previous years. It is already receiving a deduction in the current year for the amounts which are being repaid.

If you have any questions, please contact Attorney Linda R. Averbek at (513) 684-3211.

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By: _____
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